Paying for protection

Kristen Paech considers how structured products can aid retirees in falling markets

Retirees face a raft of risks in retirement, not least of which is the risk that they will outlive their savings.

This so-called longevity risk has been amplified by the recent sharemarket crash, with many retirees losing almost half of their wealth in the past 12 months.

Research by the Association of Superannuation Funds of Australia, titled *The Age Pension, superannuation and Australian retirement incomes*, reveals that those who have recently retired will need to substantially rely on the Age Pension in their retirement.

Between July 1, 2008 and mid-December, 2008 balanced superannuation funds returned between minus 10 and minus 15 per cent.

"These negative investment returns have also impacted on those currently drawing down on their superannuation savings in retirement," the report notes.

"It is clear that most recent retirees will need to substantially rely on the Age Pension in their retirement and this will continue to be the case for many years to come."

Barry Wyatt, national manager business development at Axa, says the near 50 per cent fall in the Australian equity market has brought to the fore the challenges facing financial planners and their retiree clients.

He refers to the five years prior to and after retirement as the "critical zone", and says that starting retirement with a year of negative investment returns puts retirees immediately on the back foot.

"In a normal environment, when someone retires, there's a one in 20 chance they'll run out of money over the next 20 years," Wyatt says.

"If somebody retired a year ago and they had a balanced portfolio, so a 70 per cent exposure to equities, their chance of running out of money is now one in two."

Andrew Barnett, head of structured solutions at Axa, says drawing a pension in a falling market can have a huge impact on the value of a retiree's assets.

"Retirees may have lost 40 per cent of their wealth over the last year and they have little or no ability to rebuild that wealth because they have no more human capital, they have no more earnings capacity," he says.

"That has significant implications for them; they may need to go back to work, they may need to lower spending. Potentially they'll exhaust their pension earlier than they were planning and then they will have to move to an Age Pension, which doesn't even provide a modest lifestyle in retirement."

CAPITAL GUARANTEES

Capital guarantees have a role to play in Australia's post-retirement market, as they assure the retiree receives an income over time that is at least equal to the amount that they've saved.

The US pension market has already embraced the concept with gusto. According to Wyatt, at least 60 per cent of retirement funds in the US are written with a guarantee.

Heady investment markets over the past decade have muted demand for guarantees from Australian retirees, with market growth more than making up for the incomes being drawn from allocated pensions.

Between 1995, when allocated pensions were introduced, and the end of the bull market in 2007, 2002 was the only calendar year of negative investment returns.

"For anyone in retirement it was fairly straightforward; you were taking out your 7 per cent income, but growth was more than 7 per cent, so each year your fund was ticking up," Wyatt says.

"Australians have been living in a false world for the last 13 years of allocated pensions with just one negative year. Now we've had a rude awakening in the past 12 months and I think it will change the way planners look at retirees and how they plan for retirement in this critical zone. I think guarantees will play a significant part in planning for that critical zone."

However, Andrew Robertson, chairman and managing director of Ingevity, says capital guarantees do not always meet retirees' income needs.

He says there are a number of barriers to product innovation in the Australian market, one key barrier being that Australia and its planner community have typically adopted an investment focus.

"[It is perceived that] the role of the planner is to achieve an accumulation goal at the end of a period of time through asset allocation," he says.

"In that framework a simple capital protection at that point in time is the most natural thing for a planner to get their head around. In actual fact, that really doesn't help the retiree all that much. If you get capital protection after seven, 10 or 20 years, given that the retirees' needs are income needs over a much longer period of time, that protection is not very well matched against their needs, so even when the protection bites, the payout from it is not necessarily going to help them do what they really want to do, which is fund their income."

Guarantees are most useful when structured as an income guarantee, rather than a capital guarantee, Robertson says.

"Then [retirees'] most fundamental need, which is having at least a core level of income each year, can be met as a first order of priority," he says.

"Unlike an annuity, where they need to make an all or nothing bet on just getting a steady stream of income, these products allow them to maintain access to their capital for at least a period of time; and if markets do well, to maintain access to a significant pool of allocated pension account-based capital for a long period of time. They allow retirees to better trade off their complex set of competing needs over a potentially long but uncertain lifespan."

PRODUCT INNOVATION

Structured products can provide retirees with a steady stream of income; a liquid pool of capital from which to draw on; immunisation against poor market performance; and exposure to the upside, should markets perform strongly.

Much of the innovation in the post-retirement space is occurring outside Australia, with US life insurance companies developing structured products that provide a put option insurance against market underperformance.

Product options are also emerging that allow retirees to pool their longevity risk.

"Another risk is long-term care; both health care – increased costs of pharmaceutical benefits – and increasingly costs of care in home and care in services," Robertson says.

"In the US you have seen for a while the development of products called long-term care insurance products which allow for someone to use an insurance pool to provide for contingent potentially high financing costs of that care."

John O'Shaugnessy, deputy chief executive of the Investment and Financial Services Association (IFSA), says it is important for Australia to understand the challenges at home but also to learn from what's happening abroad.

"In Australia our 'in retirement' focus or offering is somewhat immature compared to the accumulation phase offerings that we've got," he says.

"It's one of the areas where we sit behind other markets who have better developed retirement income products. Broadly, the options that we've got are moving to a mandated pension system, which is something that we wouldn't support, or making the market for income-stream products much more competitive. There are perhaps less barriers for competition sitting in that market space."

To date, most of the product development has been on the back of public policy and regulation which is "a bit aged", O'Shaugnessy says.

"We believe with the tranche of Baby Boomers coming through, the issues of longevity risk, market risk and inflationary risk are something that requires early attention, and it's fabulous that the Henry Tax Review presents an opportunity to look at [these issues]," he says.

The recent market correction may quicken the rate of innovation in Australia, with a heightened degree of risk awareness from consumers likely to filter through to the advisory world.

"Customers are going to start to be much more concerned about those contingent 'what ifs,'" Robertson says.

"That will be a big driver for product solutions because planners won't be able to solve this by themselves. A typical strategy of a diversified set of long-held assets simply doesn't do it."

Commonwealth Bank's Capital Series Australia 2nd series offers capital protection at maturity but does not pay any income stream during the life of the product.

Instead of getting a fixed rate of interest, investors receive 100 per cent of the performance of the S&P/ASX 200 Index, up to a maximum return of 80 per cent, over a 5.5-year period.

Suzanne Salter, head of structured investments at CBA, says the bank is yet to develop products in the decumulation phase. The bank's two core offers fall into the wealth accumulation phase.

"We don't currently have an offer in this space but it's something that we're looking to develop, especially as interest rates are coming down," she says.

"For that to be successful it involves the client understanding that we can't necessarily offer a fixed rate, but it would be a rate indexed to the performance of another asset, let's say the S&P/ASX 200 or the price of gold, for example."

FINANCING RETIREMENT

When choosing the right strategy for their clients, financial planners must begin to view the process of retirement planning as one of optimising retirement financing, rather than retirement incomes, Robertson says.

"Retirees are exposed to a variety of different risks," he says.

"It's going to be fundamental for planners to understand the nature of those risks and then start to seek products that help retirees better match their resources against those risks."

Ingevity is working on developing solutions that provide retirees with more income early in retirement, thus minimising the risk of outliving their savings.

This is achieved through a Longevity Insurance concept. Unlike traditional annuity products, the retiree retains more flexible access to their assets and is able to select an investment profile that suits their needs.

"Retirees have a choice; they can provide for all of these risks by choosing to draw their income in a very conservative way and preserve their capital, but obviously that comes at the cost of lifestyle early on in retirement," Robertson says.

All key indicators heading North

Axa has doubled inflows into North over the past four months, with more than $300 million now committed to the capital protection product by financial planners.

Andrew Barnett, head of structured solutions at Axa, points to increased demand due to market conditions and greater awareness from planners around the nature of the guarantee.

A new protected investment guarantee was added to the product in October last year which allows investors to insure 100 per cent of their capital over five and seven-year terms.

The protected investment guarantee complements the protected growth guarantee, launched in December 2007, which guarantees 100 per cent return of capital plus any positive market performance over 10, 15 and 20-year terms.

"With the guarantee, retirees can receive an income of up to 15 per cent of their available balance without affecting the guarantee," Barnett says.

"That's more than enough to accommodate the needs of most retirees. We find that on average, retirees take between 4 and 7 per cent of the value of the account every year."

In Australia, the majority of capital guaranteed products are based on a risk management technique known as threshold management.

According to Barnett, threshold management doesn't transfer market, inflation or interest rate risk away from retirees. In fact, he says it transforms that risk.

"In a falling market their risky assets are sold to buy risk-free assets, and then with threshold management you wait for the interest on the risk-free asset to regenerate the principal over time," Barnett says.

"But in effect, if and when markets do recover, they have a lower amount invested in the growth assets so they don't participate as much in any market recovery."

Conversely, North manages the guarantee through dynamic hedging, a form of risk management where investors pay a premium and remain fully invested in growth assets of their choice, regardless of market conditions.

"With dynamic hedging retirees can be fully invested in the growth assets of their choice and that's important because while cash is a good defensive option, it's a bad hedge against inflation," Barnett says.

"If retirees are in growth assets they have a better chance of building wealth over time that will offset, to an extent, the risk of outliving their savings."

Axa had intended to introduce a gearing option to North, but Barnett says the financial crisis has slowed progress on this front.

"We are working with several providers but the credit crisis has had an impact on the willingness of some of these providers to extend their offers in the market," he says.

"Equally, the market will take some time to recover in terms of gearing; margin lending has fallen from $37 billion to $27 billion, so it's contracted quite significantly. That said, it's still an effective tax strategy, but people are less inclined to gear [into] the market [than] they would be otherwise."

- Kristen Paech

"Alternatively they can enhance lifestyle early but run the risk of running out of money later. If they are better able to finance the contingent risks later in life, then by protecting against those contingencies cost-effectively (because they're using a product that only pays when contingency is needed), they can have the confidence to spend more of their savings early in retirement."

The concept of longevity pooling is something which can also be integrated with an allocated pension, Robertson notes.

The customer can allocate a portion of their savings to the longevity pool early in retirement, and should they live longer than expected, the longevity pool distributes additional income back into their pension.

Russell suggests retirees think of their wealth in various buckets: the essentials bucket; the lifestyle bucket; the kids' and bequest bucket; and the "endowed" bucket.

"The first bucket is: How much do I need in order to maintain what I'd consider the absolute bare minimum tolerable lifestyle?" says Steve Schubert, managing director, Russell Superannuation.

"The second bucket says, if that's the minimum I could tolerate, how much money do I need for the sort of lifestyle I desire and strive to achieve in retirement? If you've got enough money to go beyond that, people can start to plan to leave some money behind, for their children or grandchildren,

Longevity risk

With changing demographics, longevity risk is a problem for both planners and retirees.

According to PricewaterhouseCoopers, about 13 per cent of Australia's 21 million population are over the age of 65. But in 2051, about 26 per cent of the then 28 million Australians will be 65 years or older. In addition, it is expected those over 65 will be living, on average, five years longer than they are now, with an expected life at 65 of about 95.

But it should be noted the particular risk called longevity risk, actually refers to the risk for the provider of the product, the insurance company or funds manager, rather than the investor, and while it has an impact on the investor it should be considered alongside other more personal issues in post-retirement planning and products.

Certainly there are issues around longevity risk as life expectancies rise. Longevity risk exists due to the increasing life expectancy trends among policy holders and pensioners, with the result that payout levels are higher than what a company or fund originally accounted for. The types of plans exposed to the greatest levels of longevity risk are defined benefit pension plans and annuities, which guarantee lifetime benefits for policy or plan holders.

All the leading minds on the matter – consultants, actuaries, and policy makers – suggest there seems no obvious solution to the problem, apart from the acknowledgement that traditional capital market instruments seem inadequate as longevity risk hedges, and a number of providers are exploring the use of new financial instruments in their products.

Ken Mungan, global practice leader at consulting firm Milliman in Chicago, says that across the world the winning products manage the multiple risks via a simple menu-based approach, and have clear and transparent costs.

The risks include insurance, behavioural, inflation, market and longevity risks. But he says the new products will require education and the ability to demonstrate outcomes or risk management in an appropriate way, and that existing approaches to financial planning may need to be revised.

Author of *Die Broke*, Stephen Pollan, says "the last cheque you write should be to your undertaker… and it should bounce". Certainly retirees, and their advisers, have been grappling with this question for a long time – will they live longer than their savings?

Andrew Robertson, managing director of Ingevity, says advisers and investors should be exploring a number of key questions in assessing whether they will outlive savings.

How long might we live? How much income will we need and want? How much do we need saved to retire safely? What level of investment risk should we take?

"The answers are often surprising. For instance, 15 per cent of all 60-year-olds will live to age 100. The level of income projected to be required after age 85 is actually increasing due to the costs of independent living care," he says.

Actuarial firm RiceWarner has identified a $450 million retirement savings gap in Australia. This confirms what many advisers see - that a majority of Australians face the imperfect choice between living poor and dying rich or risking outliving their savings.

The Society of Actuaries in the US believes this problem is larger than just considering appropriate financial products, and it lists 15 post-retirement risks, including personal and family risks, healthcare and housing risks, financial risks and public policy risks. The Society believes that unexpected events, and their related costs and expenses, can jeopardise even the best-laid retirement plans.

- Amanda White

or make a bequest to a charity. [The final bucket] is for the super rich or super frugal who basically have so much money they couldn't possibly spend it – people like Warren Buffett."

Categorising your money in this way means you can take different approaches to each wealth bucket, Schubert says.

"Once you move beyond [the essentials bucket] and you're into funding your preferred lifestyle you can be a bit more flexible," he says.

"If you live a long time and the money starts to run out, you might have to tighten the belt a bit, but at least you're doing that from a base where you're enjoying the lifestyle you aspire to, rather than down there at the very frugal stage."

In times like this, it's important for planners with post-retirement clients to reassess clients' investment options within their superannuation funds, and consider whether the particular strategy remains appropriate.

Crissy DeManuele, technical services manager at Suncorp, says planners should also look at how they can help their clients with potentially gaining more access to Centrelink benefits.

"For example, they may be eligible for an Age Pension that they previously weren't eligible for due to their level of income or assets," she says.

"That not only provides them with some sort of income, it may also give them access to concession cards and other benefits that come along with receiving the Age Pension."

Where people's superannuation balance has declined, the tax-free components may have increased, DeManuele says.

"Moving the money into an allocated pension crystallises the tax-free component and that way, any future earnings in the allocated pension will be added back to the tax-free component in the proportion it currently holds, whereas if it's in accumulation it will potentially add back to the taxable component," she says.

Lifetime and fixed-term annuities have traditionally been viewed as inflexible by financial planners, because the money is locked away, the rate of return is low and when the client dies, the full capital is not necessarily returned to their beneficiaries.

However, they do offer certainty and a guaranteed rate of return, which in this environment is looking increasingly attractive for retirees.

"Now that post-retirees and pre-retirees have had a bit of a shock and they've seen their balances decline, they perhaps will be looking for more capital guaranteed options and you'll probably find things like lifetime annuities and fixed-term annuities may become a bit more popular," DeManuele says.

"In times like this where allocated pension balances and super balances are declining, if you have a lifetime annuity or fixed-term annuity you're still getting your fixed rate of return regardless of what's going on in the economy." ■

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